DOW THEORY LETTERS INC.

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THE MARKET: Since September 14 (the first "over-seven-million-share day on the upside) we have witnessed the most spectacular series of high-volume days in the history of the N.Y.S.E. The Rails and Industrials bettered their old highs on October 7 and 11 respectively, thereby reconfirming the primary bull trend. Between September 14 and October 25 the record N.Y.S.E. volume produced (1) an impressive rise of about 9% in the Rail Average, (2) a great amount of "churning" in the Industrials list with net progress of only about 3.2%. Concern was expressed because on some trading days which brought in volume of 8 to 9 million shares, net gain in the Industrial Average was often held to a tenth to a quarter of one percent. As far as Dow's Theory is concerned, however, as long as the two Averages move up "in gear" or together, the move is a valid one. Early last week (October 26, 27) saw a cessation of churning as the Industrial Average established impressive gains, and it appeared that a large amount of the "supply" had finally been "chewed up."

Aside from the unprecedented volume, another phenomenon of the last month has been the run-up in many speculative issues. Not since the "new issue market" of 1961 has there been such a concentrated explosion in selected issues on the exchanges. On October 21 with the Industrial Average up 1.81 points on 9.1 million shares the Union News Service remarked: "History of a sort was made on the Big Board when the daily list of the 15 most active stocks — for the first time in the recollection of most Wall Streeters — failed to include at least one issue of investment-grade quality."

This type of action would seem to imply that the public is in the market "with both feet." Yet the extraordinary thing about this market is the absence of statistics to prove that the public is an important factor in the current fireworks on Wall Street. Public sentiment is discussed in detail in another part of this Letter, but it would seem from a cold appraisal of the figures that the speculator and the semi-professional rather than the public are the ones who are now providing the action on Wall Street.

Conclusions: The primary, secondary and short term trends are all bullish. Many analysts are now offering guesses or estimates as to how long or far this advance should carry ("a new high in the short interest means a rising market for months," "Continued odd-lot selling means an advance into the Spring,") but the fact is that not a man alive has any idea what lies ahead for this sixteen-year old bull market.

The Composite Chart at right shows the two leading industrial averages at all-time highs. The A-D Ratio recorded its 1962-65 high last May. Following the May-June reaction, the Ratio

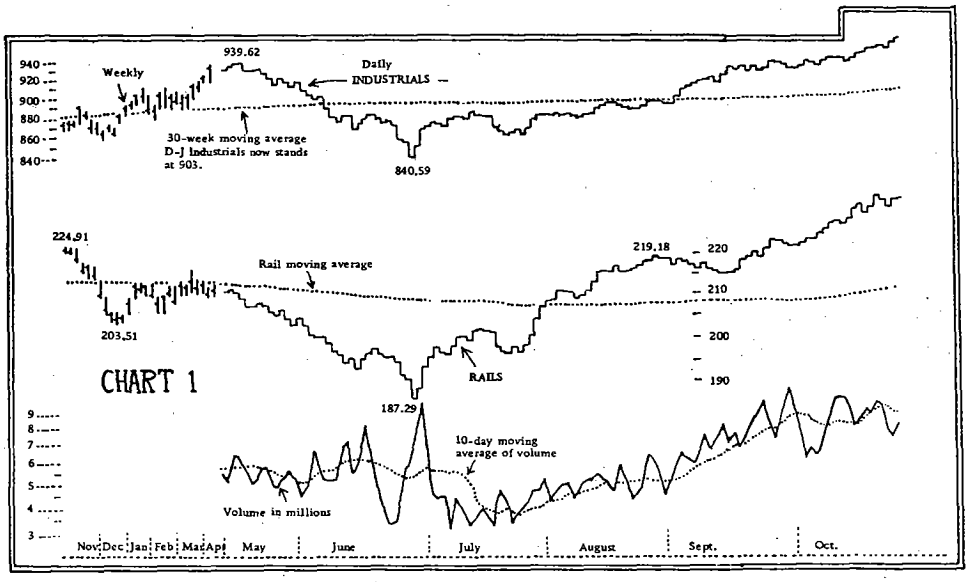
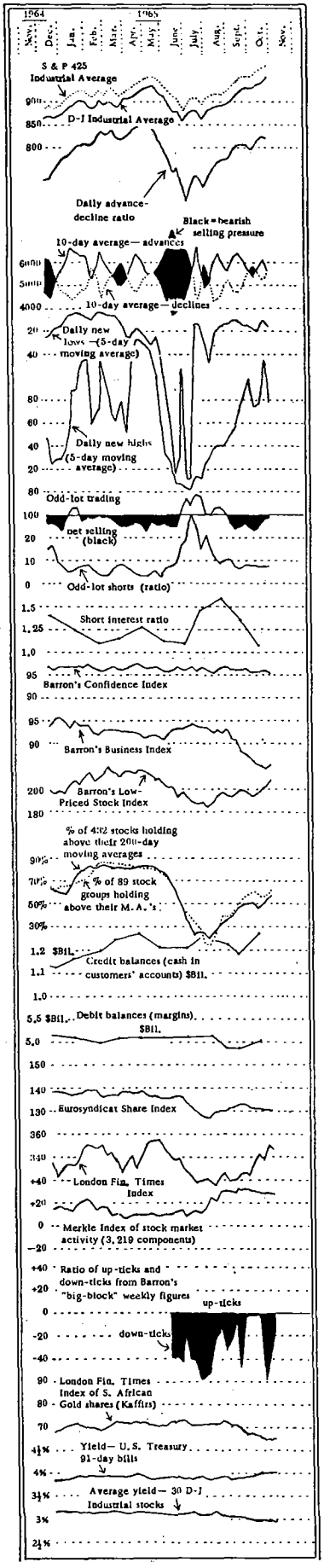


CHART 1


1964
1965
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving average)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

climbed to a recovery high on October 18. Since then it has been working sideways, and it will be important to see whether the A-D Ratio continues to work towards its former May peak — or whether this index is starting to diverge from the Averages. The lag in the A-D Ratio is being reflected in the recent contraction in the New High Index, which has now dropped back to the 70-80 area. Odd-lotters are still disposed to step up selling on any market dip, technically a continuing bullish sign for the market. The mid-October short interest rose to a record high on a big jump of 653 thousand shares. It is interesting to note that for the first time since 1951 the total Short Interest climbed to a high for the year while the Short Interest Ratio simultaneously dropped to a low for the year (at 1.06). Nevertheless, I rate this indicator on the plus side, since any forthcoming drop in volume will send the S.I. Ratio sharply higher. Barron's Confidence Index broke last week to a new low for the year at 95.4, and this indicator is saying "danger" (it has been in a downtrend for a full year). The percentage of stocks holding above their moving averages rose 3% last week to 57%, a positive technical indication for the market. Debit balances rose $108 million during September, reflecting some build up in speculators' margin accounts, but this index is still far below its November, 1963 peak. Credits are discussed in the next section. The Eurosyndicat Index, reflecting the average price of Europe's 100 largest corporations, is listless at 130. London has recovered and is bouncing around its June top of 350. The Merkle Index (computed by Dan Merkle of Traders Research) continues its remarkably reliable performance, and is still holding in the 25 area (well above the critical zero dividing line). Barron's Big Block transactions indicate further distribution with a minus 16 reading for the week ending October 22. As suggested in the last Letter, the British-Rhodesian crisis shows promise of easing. Most of the leading S. African gold shares which have been recommended here continuously (Western Areas, Western Deep Levels, Free State Geduld, President Brand, West Driefontein) have held amazingly well, although the Kaffirs Index itself has dropped. Since the golds I recommended were "growth golds" and the Kaffirs Index is made up of largely low-profit margin producers, that Index has not accurately reflected the price of shares which we hold. During August-September, as the probability of a near-term British devaluation faded, the low-profit-margin producers sold off, and it is these issues which have depressed the Kaffir Index rather than the aforementioned shares (all of which, by the way, I still recommend at today's prices).

FROM HERE AND THERE: The following comments have been gleaned from all points during the past week. They interested me, and I believe they will interest subscribers. "Meanwhile, back at the central bank, monetary policy remains exactly as it was. While fear of inflation stalks the hall of the Federal Reserve Board as a constant Banquo's ghost, the Chairman, Mr. Martin, and his colleagues on the board have taken no action to avert an overheating that even they cannot be sure is coming. Although Wall Street buzzes about an increase in the discount rate, the Federal Reserve authorities let it be known that the current policy is wait and see. Mr. Johnson may be in the hospital, but the lack of a gall bladder has in no way impaired his spleen: an increase in the discount rate seems a remote possibility." (from the London Economist, Oct. 16).

"Officials still are not satisfied with the trend of industry's direct investment abroad, although they have tried hard to avoid any impression that the program on business investment run by Commerce Secretary Connor has broken down. And, despite the encouraging outlook for next year, they are not ruling out the need for controls on tourist spending. This adds $1.9 billion to the dollar outflow, and remains a tempting place to cut." (Business Week, Oct. 23).

(Regarding the I.M.F. meeting) "The Germans .... feel that they are increasingly allied with the French, and while they do not take the view that there is too much world reserves, they see no urgent need for more....They believe that the need for additional world reserves would be small if all leading nations aimed at an equilibrium in payments, and that therefore the fundamental problem is one of discipline on the part of the deficit countries, which often conflicts with expansionary home economic policy aimed at full employment and sustaining business booms." (from The Magazine of Wall Street, Oct. 16).

(Regarding U. S. fiscal policy) "But one can be skeptical about the ultimate outcome. Regardless of how noble and humane our objectives may be — how right the reasons are — we could be doing the wrong thing by using the Government's role to keep the economy always under forced draft. It is no longer a matter of compensatory action because the compensatory principle works like a two-way street where traffic moves in both directions. The expansionists insist that the Government's role is one-way, always stimulating. Proper application of the compensatory principle requires the public segment (the Government segment) of the economy to enlarge its role when the private segment declines and to curtail its activities when the private segment is booming. But we are not reducing the Government's program even in the most prosperous of times, or reducing the Federal debt either. In fact, we have been using measures that one would expect to be reserved for a period of declining business." (from the Bank Letter, First National Bank of Dallas, Oct. 15).

"Now that Great Britain has followed Japan and Italy into deflation, the dollar is the most exposed currency of any importance. Whether the Fed tightens money further in the near future, or waits like the British until the crisis strikes, is immaterial to the owners of gold stocks. The past month has accelerated events." (from the October Monetary Report by Alden Wells).

"Last week, as the stock market was rising to its record high, the average yield on the S & P 550 Stock Index declined to 2.92%. At the same time, the average yield on Moody's Aaa-rated corporate bonds was 4.58%, the highest in about four years. A comparison of the two figures shows a 'negative yield spread' of 164 basis points, the widest such spread on record. A basis point is one one-hundredth of a percentage point." (from the New York Times, Oct. 17).

Conclusion: The technical condition of the market suggests higher prices, but there are enough danger signals so that true Dow Theorists would rather distribute than accumulate as (and if) this market moves higher.

WHERE IS THE PUBLIC? Perhaps the most extraordinary thing about this market is the data being released pertaining to the action of the public. On October 19 it was announced that Customers' free credit balances or the cash in Stock Exchange customers' accounts had risen $177 million for the month to a total of $1.36 billion dollars. As seen on the accompanying chart (Page 3), this is the largest amount of cash in Exchange customers' accounts since June, 1962 (when the 1962 market crash scared the customers out of stocks and into greenbacks). In view of the attractive rates of interest now being offered by savings institutions, it is even more remarkable to see this cash piling up in customers' accounts. There is only one conclusion that can be drawn — the public is becoming increasingly worried about the market as it rises. The greater the market advance, the more willing the public is to sell its securities and pile up cash.

"But isn't this intelligent procedure?" I am asked. "Isn't the public showing real sophistication by selling stocks during an advance?" On the face of it, the public does seem to be exhibiting uncommon sense, but unfortunately, it usually does not work that way in the end. Market history shows that the public tends to greet an advance with some skepticism. In this the public seems to be saying, "Stocks are much higher than they were before, and they are therefore a sale." But as the advance continues,

the skepticism generally evaporates and the public switches to buying — often avid buying. Here they seem to say, "The market is still high, but it is going higher and I can still grab some of the profits before the rise ends." This latter psychology marks the beginning of classical technical deterioration, and it is the type of psychology which leads to a top.

A second "gauge" of public sentiment is seen on the Composite Chart (Page 1), and here again we see that the odd-lotter (whose actions are generally conceded to be indicative of the public) has been skeptical about the market; he has been a seller month after month. This checks with the aforementioned credit balance statistics. It suggests that the public is steadily selling more shares than it is buying, and that a portion of the receipts for these shares is being kept in brokerage houses in the form of cash.

A third "check" on public activity is seen in the accompanying chart of odd-lot volume as a percentage of total volume on the N.Y.S.E. The percentages since July have all been under 7.5%, and during September and October these percentage figures have dropped under 7% — record low figures. In other words, the odd-lot public is accounting for a smaller and smaller percentage of the activity on the N.Y.S.E.

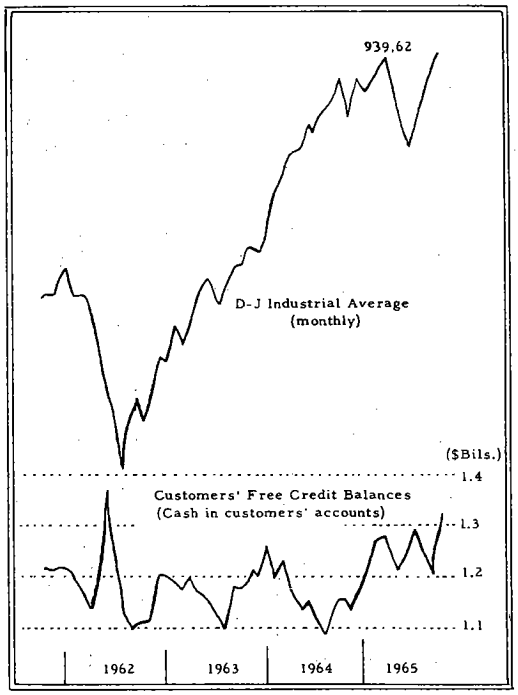
Where is the public? What has it been doing, and why is there such wide national interest in the market if the public is so totally absent from Wall Street? One answer to this can be put into two words, Mutual Funds. A totally new phenomenon of the market of the '60's seems to be the transfer of public enthusiasm from the major exchanges to the Mutual Funds. Over the past year fund purchases have broken all records, and perhaps more significant is the ratio of fund purchases to fund redemptions. This study and the accompanying chart provides some clue as to where the public is and where it has been putting its money.

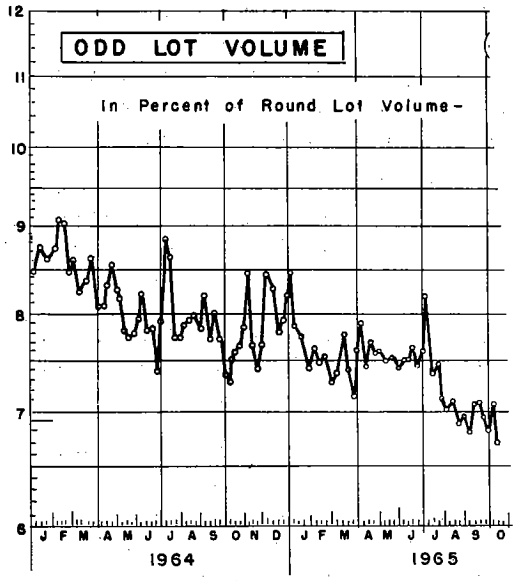
Note that the fund buyer's reaction to the rising market in 1963 and early 1964 was somewhat skeptical, and the ratio of purchases to redemptions bounced around the 60 to 70 area (70 indicates that 7 fund shares were redeemed for every 10 purchased). In early 1964 the ratio dropped well below 70, suggesting a further move to caution. But for the rest of 1964 public confidence rose, and by early 1965 the fund ratio had advanced to above 40, showing that the public was buying almost 3 shares for every 1 redeemed (a high state of optimism).

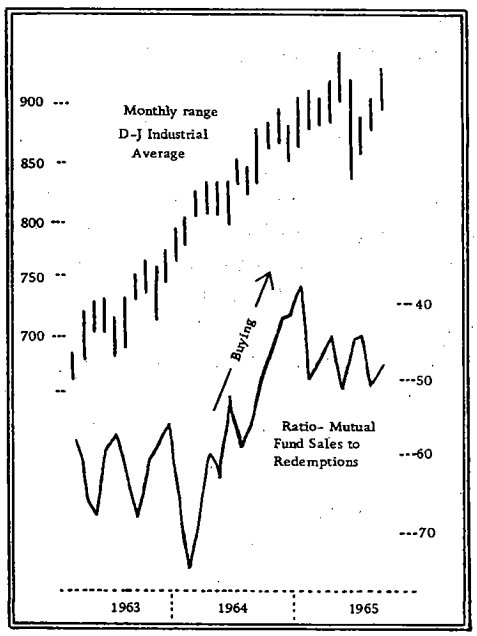
In all of 1965 (during which actual fund sales boomed), the fund ratio held in the 40-50 area, indicating roughly a 2 to 1 ratio of fund purchases to redemptions. In other words, the chart would seem to be saying that much of the odd-lot public's enthusiasm has now switched over to Mutual Funds, rather than the exchanges. My own theory is that the public has been saying, "I learned my lesson during the 1962 crash. From now on, if the market looks higher to me I'm letting the professionals do the buying; I'm putting my money in Mutual Funds and the devil with odd-lots on the Big Board." This type of thinking would go a long way towards explaining the current record total of Mutual Fund purchases as well as the current record low percentage of odd-lot volume on the N.Y.S.E.

ADVANCE-DECLINE: In Letters 299 and 300 I drew attention to the unprecedented string of days in which advances outnumbered declines (i.e., advancing days for the A-D ratio). Starting with July 28, the A-D ratio rose on 16 consecutive days. A three-day decline in breadth followed, whereupon the A-D ratio rose for another 14 consecutive days. This constituted an all-time stock market record for the A-D ratio, a record which showed 30 days of advance out of 33 trading days.

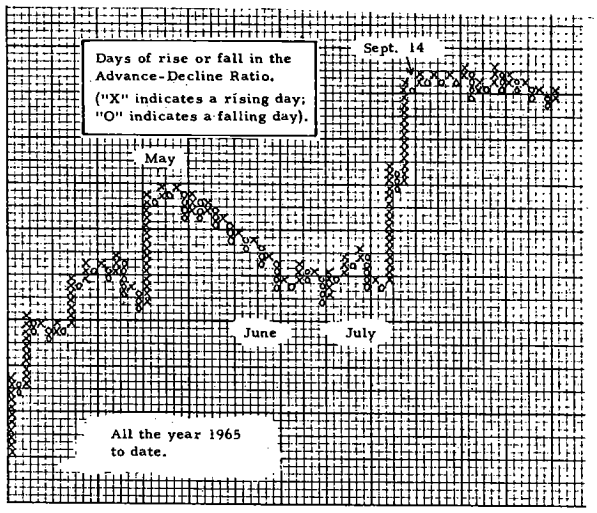
I wrote at the time that over any reasonable length of time the tendency of the A-D ratio is to "even out." For instance, over a one year period there would tend to be about as many days of advance in the A-D ratio as decline. The year 1965, however, is heavily weighted on the upside as shown on the accompanying point and figure chart (Page 4). It should be remembered that







this chart is not a representation of the actual A-D ratio; it only depicts the A-D ratio in terms of whether that Index as a whole moved up or down. An "X" is placed on the chart on any day in which the A-D ratio advanced (i.e., any day when there were more advances than declines), and an "O" is placed on the chart on any day when the A-D ratio declined. Obviously, all rows of X's indicate consecutive days of advance; all rows of O's indicate consecutive days of decline.


Days of rise or fall in the Advance-Decline Ratio.
("X" indicates a rising day; "O" indicates a falling day).
Sept. 14
May
June
July
All the year 1965 to date.

Note that the long string of up-days in April give way to the decline into May and June (with an accompanying 100 point drop in the Dow). A period of consolidation occurred in early July, followed by the remarkable string of advancing days which took place during July to September. This string of up-days terminated on September 14, as seen on the chart.

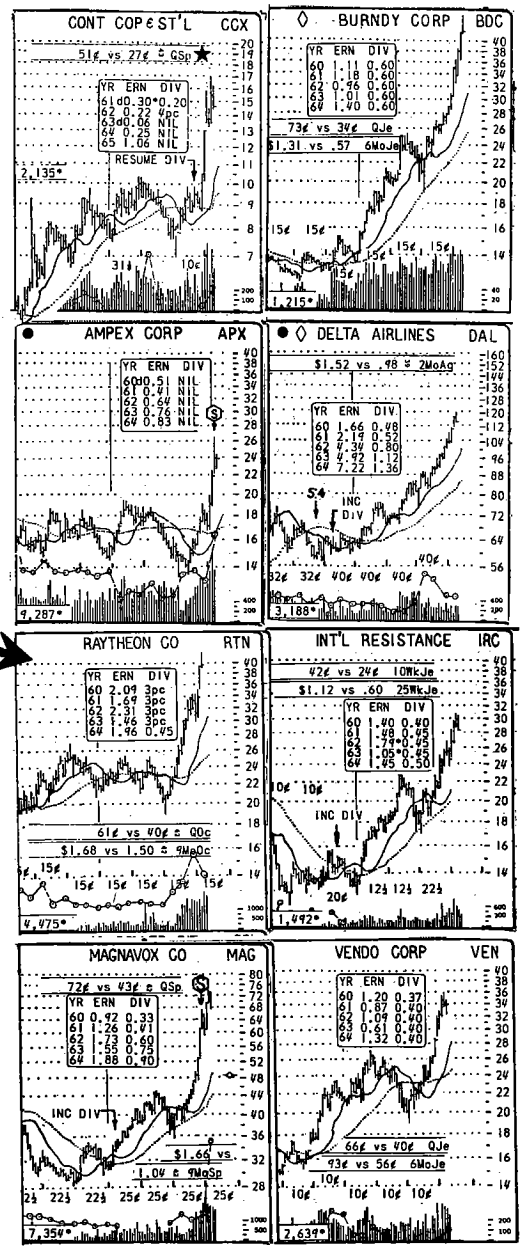
Since then, although few have noticed it, the tendency of the A-D ratio has been to produce about as many down-days as up-days, and consequently the chart has produced a sideways or lateral formation. This chart is essentially a "swing chart" in that the normal tendency is for it to oscillate up and down rather than "travel" continuously in one direction. The fascinating question which now presents itself is whether the sideways action since September 14 is going to take the place of a downward correction in the A-D ratio, or whether the current lateral pattern in the A-D is the first major interruption of the upward momentum, preparatory to a major downward correction which might serve to take the A-D ratio back to at least the June-July level? My own guess is that the market will not produce another string of rising days in breadth, and that from wherever the current sideways formation ends, we will be subject to our first sustained decline in the A-D ratio (and probably in the Averages as well).

50% RULE: A subscriber visited me last week, and one of his first comments was that he owned three of the "high flyers," the stocks which have been rocketing over the past month. The subscriber wanted to know at what point I considered these stocks a "sale." My answer was in the form of a rule which I have used with success over the years, and I call this the 50% rule.

The 50% rule states that any time a stock rises 50% or more above its long-term (30-week) moving average, it is highly vulnerable from a technical standpoint. In such cases, the odds favor that stock's declining, and within six months touching or breaking its long-term moving average.

Like so many other market "rules," this rule is merely an observation. It is no more "certain" than a doctor's diagnosis of a disease, but I have seen the 50% rule work perhaps seven out of ten times.

Each week this observer studies charts of all stocks on the N.Y.S.E. as shown in the Quote Digest chart book. It is noteworthy that at this time there are approximately 24 stocks on the N.Y.S.E. to which the 50% rule can be applied (the average number during any given period usually runs around 5). I have included charts of some of the more prominent of these issues below. Readers interested in testing the 50% rule might construct a weekly or bi-weekly average of these stocks (simply add the price of the 8 stock at right and divide by 8), and then check the price of this average during the next six months.



Chartcraft (Larchmont, N.Y.) lists Radio-TV, Saving & Loans, Machine Tools, Vending Machines and Electronics as the strongest groups on the N.Y.S.E. on the basis of relative strength momentum studies. Among assorted speculative choices, the following stocks look interesting to me on the basis of (1) the size of the base formation, (2) point & figure projection, (3) current bullish status, (4) favorable relative strength. These stocks are Fansteel, Eversharp, General Time, Marquardt Corp., Robertshaw-Controls, Union Bag-Camp Paper. For the longer term, I continue to feel that "discounted" one-year puts will be profitable. Among stocks which are attractive for this purpose are Sears, Georgia-Pacific, May Co., Macy's, Fed. Dept. Stores, Motorola, Magnovox, General Foods.

Chart of odd-lot volume (Page 3) courtesy of Merrill Analysis, Box 228, Chappaqua, New York. 10514

Page 4 stock charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.